

"Cup of Joe"

Spring has sprung, and so has inflation. While this has been a long time coming, we wanted to inform our clients of the risks the markets face today, how we will protect against these risks and what we see moving forward.

First, what is inflation? Inflation is a decrease in the purchasing power of money, reflected in a general INCREASE in the prices of goods and services in an economy. The Federal Reserve, who control the level of interest rates, have been trying to stimulate an increase in inflation for years. As a result of the trillions of federal stimulus dollars injected into the system to support the economy and employment in the wake of the COVID crisis, we are finally seeing signs of inflation. So, why is inflation bad? Let us use the cost of wood as an example. Given the amount of extra stimulus money in everyone's pockets, we all decided to build decks and remodel our homes at the same time. This increase in demand, coupled with the lack of production due to COVID over the last year, has resulted in sky high lumber prices. If you want to build a house, the cost just doubled. This either deters the consumer from building (hurting the economy), or it takes double the amount of money out of the consumer's pocket to move forward with the house (hurting the economy). When inflation gets out of control (hyperinflation), the Federal Reserve controls it by raising interest rates. Higher interest rates are also a drag on the economy. *The higher the interest rates for loans, the more it costs to buy a house, car, etc., essentially sucking the money back out of the economy. The idea is to reduce the demand for wood and the price will go back down.

Inflation can be a good thing as well. Given the "Amazon Effect" (Amazon matches or beats the price of its competitors; therefore, the consumer always gets the lowest price for everything they buy) that we have been experiencing over the last few years, costs have been kept down. The consumers have learned to hold off until they find the best deal. This reduces demand, which leads to less production and a faltering economy. With rising inflation, more dollars equate to more demand, which in turn, increases productivity and hiring practices to meet that demand. And with inflation comes rising wages and even more money for people to spend. And that is good in moderation!

What we DO NOT want is hyperinflation over a longer period of time, causing the Federal Reserve to step in and raise rates too quickly. If this were to happen, the markets would surely pull back and volatility would increase mightily.

Today, economists are monitoring inflation numbers closely. We feel as though inflation will spike higher in the next year, and rightfully so. With many predicting a “roaring twenties”-like economic rebound, demand for goods and services will follow. And with an increased amount of stimulus and personal savings chasing too few goods and services, prices will have to rise. The good news is that lumber prices have already come down by 40%. This adds to our thesis that inflation will be temporary.

In our portfolios, many you have probably noticed that we own quite a bit of Treasury Inflation Protected Bonds or “Tips”. This type of treasury bond’s principal amount increases with inflation and decreases with deflation. This strategy that we have employed in your portfolio’s has worked well over the last year and we will continue to maintain our positions until we see signs of prices coming back down.

Other occurrences that could impact the markets and cause some near-term volatility would be the possible changes in the capital gains tax rates for people **MAKING OVER ONE MILLION DOLLARS PER YEAR**. The way this would work is that for those with income **of over $1 million** per year, long-term capital gains would be taxed as ordinary income for tax purposes. And under the proposed plan, the highest tax bracket would be 39.6% (up from 37.0%), and the Medicare surtax of 3.8% would still apply.

Note: this would merely put the tax rates back to where they were a few years ago. These changes might initiate a desire for some wealthy individuals to take some of their gains now at the lesser rate, creating a short-term reason to sell. As of today, the government is looking to make this retroactive back to April of 2021 to prevent the wealthy from reacting. **A quick reminder; we have very few clients that would be impacted by any of these proposed changes in federal tax law.**

While noting the risks to the market above, we feel as though it is always better for the markets to climb a wall of worry, rather than experience irrational exuberance. And that is exactly what has been occurring. The other good news is that inflation is rising in the expected areas affected by COVID, and not throughout the entire economy. This is bolstering the case that the inflation will be transitory in nature, giving the markets a big sigh of relief.

On a more positive note, we feel that any near-term volatility would be a buying opportunity for investors sitting on the sidelines in cash. Areas of optimism would include:

- Fed not raising rates for the foreseeable future (2023).
- Incredible amount of monetary stimulus washing around.
- Infrastructure plan creating more jobs and injecting more fiscal stimulus into the economy.
- Impending Economic Boom not seen since the Roaring Twenties.
- Consumers have incredible amounts of money in cash/savings.

All in all, we are watching inflation closely while remaining optimistic about the markets moving forward. Should inflation start to get out of hand, we are prepared to make the necessary moves to hedge against this risk. But again, we want to reiterate that so far, indicators look positive, and the economy looks strong.

We hope everyone stays safe as we look forward to returning to a sense of normalcy and to another great year of returns.

-Joe, Ryan, and the Chapel Hill Investment Team

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